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17.0 MISCELLANEOUS

17.1 TREATMENT OF FRINGE BENEFITS - BACKGROUND

Generally, we do not pursue fringe benefits as an independent issue. However, we will pursue fringe benefit issues in conjunction with other issues if tax potential warrants such examination. This chapter identifies special rules applicable to fringe benefits provided by S corporations.

17.2 TREATMENT OF FRINGE BENEFITS - FEDERAL/CALIFORNIA LAW

Generally, the rules applicable to C corporations apply to fringe benefits provided by S corporations. However, where the employee receiving the fringe benefit is also a "2-percent shareholder" in the S corporation special "partnership" rules apply. (See IRC §1372.)

Pursuant to IRC §1372 (R&TC §23807), the rules applicable to fringe benefits provided by a partnership to a partner apply to fringe benefits provided by an S corporation, if the recipient is a "2-percent shareholder". A recipient is a "2-percent shareholder if the recipient owns more than 2 percent of the outstanding stock of the S corporation or stock possessing more than 2 percent of the total combined voting power of all stock in such corporation, on any day during the S corporation's taxable year, taking into account the attribution rules contained in IRC §318. (IRC §1372(b)) Once the recipient is determined to be a "2-percent shareholder," the fringe benefit rules are applied as though the S corporation was a partnership and the "2-percent shareholder" was a partner. (IRC §1372(a))

While IRC §1372 does not identify the specific fringe benefits to which it applies, the legislative history indicates that IRC §1372 was intended to govern the following types of statutory fringe benefits:

- Group term life insurance exclusion of $50,000 (IRC §79);
- Accident or medical health insurance plans (IRC §§105 and 106); and
- Meals and lodging furnished for the convenience of the employer (IRC §119).
- (Sen. Rep. No. 97-640, 2nd Sess., p. 22 (1982))

In addition, IRC §1372 may apply to other fringe benefits that are only available to C corporations, such as cafeteria plans (IRC §125).

The following list includes fringe benefits that are available to partners in a partnership, which should not be affected by IRC §1372:

- Employee achievement awards (IRC §74(c));
- Qualified group legal services plans (IRC §120);
- Educational assistance programs (IRC §127);

- Dependent care assistance programs (IRC §129);
- No-additional-cost services (IRC §132(b));
- Qualified employee discounts (IRC §132(c));
- Working condition fringe benefits (IRC §132(d));
- De minimis fringe benefits (IRC §132(e)); and
- On-premises athletic facilities (IRC §132(j)(4)).

17.3 METHOD OF REPORTING 2-PERCENT SHAREHOLDER FRINGE BENEFITS

There is currently only one acceptable method for reporting fringe benefits although an IRS Publication 589 (1990) suggested a second acceptable method for reporting fringe benefits S corporations provide to their 2-percent shareholders. The first method, which treats the 2-percent shareholder as a self-employed individual and requires the fringe benefits to appear as separately stated items on the 2-percent shareholder's schedule K-1, is no longer an acceptable method. IRS Publication 589 (1990) is outdated and no longer in circulation. Pub 589 is not accessible online at the IRS website so the publication is no longer in circulation. Method one is inconsistent with the statute and it is certainly inconsistent with the later published Rev. Rul. 91-26. It also has a different tax effect inasmuch as the shareholder is not required to include the fringe benefit amount in income as compensation, but is allowed to deduct the amount. The second method treats the fringe benefits as guaranteed payments under IRC §707(c), which must be reported as compensation on the 2-percent shareholder's Form W-2. (See Rev. Rul. 91-26.) The instructions to IRS Form 1120S only specifically refer to the second method. Accordingly, if a shareholder reports fringe benefits under Method One, it should be adjusted to conform to Method Two, which is consistent with the IRC §1372.

17.4 TREATMENT OF FRINGE BENEFITS - METHOD 1: SHAREHOLDER AS SELF-EMPLOYED INDIVIDUAL

The first of two allowable methods for determining the tax treatment of employee fringe benefits refers to the shareholder as a self-employed individual. In this case, the S corporation cannot deduct shareholder fringe benefits on the corporation return. Instead, these benefits pass through to the shareholders.

Method 1

The corporation is not allowed a deduction for payment of fringe benefits to its greater than 2% shareholders. These shareholders are treated as self-employed individuals. The shareholder is allowed a “self-employed” deduction for the fringe benefit on their individual return.

Example A

In 2002, ABC, Inc., an S corporation, paid fringe benefits for health insurance worth $5,000 on behalf of its more than 2 percent shareholders. The corporation treats these shareholders as self-employed individuals and their health benefits are not considered compensations. Payment of the $5,000 is not deductible by ABC, but passes through to the shareholders as an item of deduction on their individual returns.

The shareholders also treat the health insurance benefits as if they are self-employed and take a deduction limited to 70 percent of the expenditure (70% of $5,000 = $3,500). They treat the balance of the health insurance expenditure ($5,000 - $3,500 = $1,500) as an itemized deduction that is subject to the 7.5 percent AGI limitation.

Note: The allowable percentage (IRC §162(l)) for the deduction is as follows:

Tax Years 1999-2001= 60%
Tax Year 2002= 70%
Tax Years 2003 and after = 100%

17.5 TREATMENT OF FRINGE BENEFITS - METHOD 2: GUARANTEED PAYMENTS

The second method treats fringe benefits as "guaranteed payments" under IRC §707(c), which means that the S corporation may deduct the fringe benefits as compensation for services and the 2-percent shareholder must include the fringe benefits in gross income as wages. This method comes from Rev. Rul. 91-26, which held that "fringe benefits paid or furnished by an S corporation to or for the benefit of its 2-percent shareholder-employees in consideration for services rendered, are treated for income tax purposes like partnership guaranteed payments under §707(c) of the Code." Where guaranteed payment treatment applies, the S corporation's deduction is permitted by IRC §162.

Method 2

The S corporation treats the fringe benefit as a wage expense.
The shareholder treats the fringe benefit as compensation.

Example A

ABC, Inc., an S corporation, provides fringe benefits such as health insurance to any two percent shareholders. ABC paid $5,000 in insurance premiums. The corporation treats the shareholders as having received the health insurance as additional compensation and includes the insurance expenditure as W-2 wage income. The $5,000 is deducted by ABC as compensation and is subject to payroll taxes. The shareholders report the health insurance as income.

17.6 SPECIAL RULES APPLICABLE TO S CORPORATION INTEREST

If an S corporation pays interest to persons who are related to the S corporation, the S corporation is not entitled to the deduction for interest contained in IRC §163 until the year that the related person's accounting method would require the inclusion of the interest in the related person's income. (IRC §267(a)(2)) IRC §267 governs the deductibility with respect to transactions between related persons. For purposes of this timing rule, related persons include:

- A shareholder in the S corporation;
- Members of a shareholder's family;
- A C corporation, if the same persons own more than 50% in value of the outstanding stock of the S corporation and the C Corporation;
- Another S corporation, if the same persons own more than 50% in value of the outstanding stock of both S corporations; and
- A partnership, if the same persons own more than 50% in value of the outstanding stock of the S corporation and more than 50% of the capital interest, or profits interest in the partnership. (IRC §§267(b) and (e))

In addition, for purposes of determining whether a payee of interest is a related person described above, special attribution rules apply, which are contained in IRC §267(c).

Verify that the related persons/creditors are reporting interest income in the same year that the S corporation is deducting interest expense in regard to S corporation indebtedness to the related persons/shareholders. If not, the interest expense is not an allowable deduction to the S corporation in that year.

17.7 BELOW-MARKET INTEREST RATE LOANS; IRC §7872

17.7.1 In General

IRC §7872 governs the tax effect of loans with no stated interest rate or a below-market interest rate.

IRC §7872 applies to term loans made after June 6, 1984, and to amounts outstanding on demand loans after such date. Any loan that is renegotiated, extended, or revised after June 6, 1984 is treated as a loan made after that date. (P.L. 98-369, §172) R&TC §17024.5(c)(1), R&TC §18180, and R&TC §24993 conformed and became applicable to IRC §7872 on or after January 1, 1987.

17.7.2 Interest on Shareholder Loans to S Corporations

When corporate-shareholder loans have a stated interest rate that is less than the applicable federal rate (AFR), the difference between the amount of interest called for by the terms of the loan (i.e., stated interest), if any, and the amount of interest that would be required using the AFR is called “forgone interest.” When this occurs, IRC §7872 prescribes the tax ramifications for the shareholders and the corporation: (1) the S corporation and the shareholder will be treated as if the shareholder loaned the forgone interest to the S corporation on the last day of the calendar year; and (2) the S Corporation and the shareholder will be treated as if the S corporation immediately paid the forgone interest back to the shareholder.

The below-market loan rules can be applied in a three-step process:

- Determine if the transaction falls within the scope of IRC §7872 (i.e., produces a below-market loan).

A term loan is a below-market loan if the amount loaned exceeds the present value of all payments due under the loan, determined as of the day the loan is made, using a discount rate equal to the AFR in effect for the day the loan is made. (IRC §7872(e)(1)(B))

A demand loan is a below-market loan if interest is payable at a rate less than the AFR. (IRC §7872(e)(1)(A))

- If it does, calculate the forgone interest.

  The amount and timing of forgone interest differs for demand loans and term loans. Refer to Proposed Regulation §1.7872-13.

- Determine the character and timing of the deemed transfers.

The deemed transfer of the forgone interest from a shareholder to an S corporation is considered a capital contribution by the shareholder followed by simultaneous payment of interest by the corporation to the shareholder. (Prop. Reg. §1.7872-4(d)). IRC §7872 treats the shareholder as if he paid interest at the applicable federal rate, which has the effect of requiring the S corporation to recognize interest income that will flow through to all of the S corporation's shareholders. The shareholder would receive a "deemed" distribution of this amount. The shareholder would also receive an interest deduction, depending on the use of the loan proceeds determined under PIT law. The treatment of loans from the S corporation to its shareholder includes: (1) the deemed transfer of the forgone interest from the S corporation to the shareholder is treated as a distribution of money subject to IRC §1368; and (2) the shareholder is treated as if he immediately paid back the forgone interest amount as interest. (Prop. Reg. §1.7872-4(d)) The deemed transfers with regard to demand loans are deemed to occur on December 31. (IRC §7872(a)(2)) The deemed transfers with regard to term loans are deemed to have occurred on the date the loan was made or, if later, the date the loan first became subject to IRC §7872. (IRC §7872(b)(1))

The effect of IRC §7872 might result in a wash for some shareholders. If the shareholder is the sole shareholder in the S corporation, or all of the S corporation's shareholders have made proportional loans with identical percentages of forgone interest, the shareholders will each get an increased basis, receive taxable interest income, and receive an offsetting interest deduction passing-through from the S corporation. The following conditions could cause the imputed interest not to result in a wash:

- If the corporation reports on a fiscal year, the timing of the imputed interest can cause an acceleration or deferral of the tax consequences. The shareholder will report the interest income in one year and get the benefit of the reduced pass-thru in the following year.

- If the corporation has multiple shareholders, and loans are not made in proportion to stock ownership, the imputed interest will not wash because the corporation's deduction for the imputed interest expense would pass through in proportion to stock ownership. Overall, however, it would result in a wash when considering that the other shareholders would receive reduced pass-thru items.

- If the interest expense pass-thru to the shareholder is considered from a passive activity, a certain portion of the pass-thru interest income will be treated as passive (not portfolio) income. This is referred to as self-charged interest.

- If the shareholder has limited investment interest expense, the imputed interest would allow a corresponding amount of investment interest expense to be deducted.

Please be aware of the de minimis exception contained in IRC §7872(c)(3), and the exception for transactions with no significant tax effect (Prop. Reg. §1.7872-5(b)(14)).

Example A

ABC, Inc. is an S corporation, and Mark owns all of its outstanding stock. Mark loans $100,000 to ABC and receives a written demand note with no stated interest rate. Assume the blended annual short-term AFR pertinent to demand loans is 7.5% and further assume that ABC has $100,000 of pass-thru income. The following illustrates the tax consequences with and without adjustment for imputed interest:

	Without Imputed Interest	With IRC §7872 Interest Adjustment
Pass-thru income from Schedule K-1	$100,000	$92,500
IRC §7872 interest income to Mark	-	$7,500

Under IRC §7872, ABC is assumed to have paid Mark $7,500 of interest (7.5% x $100,000 outstanding loan for the year). The corporate income is reduced for the imputed interest expense, and Mark's personal interest income is increased. Also, Mark is deemed to have made a simultaneous contribution of capital to the corporation in the amount of the $7,500, thereby increasing his tax basis in the stock by $7,500. The $7,500 interest payment by ABC would decrease AAA. In this example, AAA would be increased by $92,500, not $100,000.

In this example, there would be no tax effect, with the exception of the 1.5% (2.5%) reduction in tax at the S corporation level in regards to the interest expense deduction.

17.7.3 Interest on S Corporation Loans to Shareholders

In regard to the loans from the S Corporation to the shareholders, because the interest is treated as a deemed distribution, the question arises as to whether a disproportionate distribution results which could result in a second class of stock and terminate the S election. (IRC §1361)

A below market loan between an S corporation and one or more of its shareholders will not cause the corporation to have more than one class of stock under the Regulations, provided that the loan agreement was not entered into with the principal purpose to circumvent the single-class-of-stock requirement and, therefore, was not a "governing provision" (Treas. Reg. §1.1361-1(l)(2), Example 5).